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A NEW APPROACH TO "HOLDER" CONUNDRUMS UNDER ARTICLE 3 OF THE UNIFORM COMMERCIAL CODE—A REPLY TO PROFESSOR WHITE

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One of the few remaining controversies regarding Article 3 concerns the creation, transfer, and significance of "holder" status.[1] Although holder status is clearly a prerequisite for valid indorsement,[2] effective discharge,[3] certain procedural advantages,[4] and for protection against many defenses,[5] scholars continue to debate its proper role under the Code in several unusual factual situations.[6] Problems arising from these situations include the effects of conversion of certain types of negotiable instruments upon the holder status of subsequent transferees, the role of holder status in determining the consequences of alteration, and the creation and transfer of holder status in situations involving double forgeries. This article reviews past analysis of these conundrums and suggests that the difficulties should be attributed

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1 See White, Some Petty Complaints About Article Three, 65 Mich. L. Rev. 1315 (1967); Mellinkoff, The Language of the Uniform Commercial Code, 77 Yale L.J. 185, 192-94 (1967); Palizzi, Forgeries and Double Forgeries Under Articles 3 and 4 of the U.C.C., 42 S. Cal. L. Rev. 659 (1969); Comment, The Concept Of Holder In Due Course In Article III Of The Uniform Commercial Code, 68 Colum. L. Rev. 1573, 1574 (1968); Comment, Commercial Transactions: Can a Thief Be a "Holder"? 19 Okla. L. Rev. 179 (1966).

2 U.C.C. § 3-202(2). [All citations to the Uniform Commercial Code in this article will be to the 1962 Official Text unless otherwise indicated.]

3 See, e.g., U.C.C. §§ 3-603(1), 3-604(1).

4 U.C.C. § 3-307(2). For an extensive discussion of this point see Kinyon, Actions on Commercial Paper: Holder's Procedural Advantages Under Article Three, 65 Mich. L. Rev. 1441 (1967).

5 U.C.C. § 3-305.

6 See, e.g., R. Speidel, R. Summers & J. White, Commercial Transactions Teaching Materials 1027-28 (1969).

not to drafters' ineptitude, but rather, to an incomplete or faulty interpretation of the relevant Code sections. The arguments and proposals presented here are intended principally as a reply to Professor J. White,[7] who was apparently the first to consider these issues in the context of Article 3 and whose analysis has been accepted widely and, perhaps, too uncritically.

I. Effects of Conversion Upon the "Holder" Status of Subsequent Transferees of Bearer Paper and Instruments Payable to the Thief's Order

The first and most frequently discussed conundrum arises in connection with indorsements forged upon stolen instruments. Consider two demand notes drawn by Able:[8] the first payable to bearer, the second payable to the order of Baker. Baker steals both instruments from Able's desk, indorses the second instrument with his own name, and delivers them to Donald. Assume, further, that Donald complies with the requirements of holder in due course status under 3-302 (1) and receives the instrument in good faith, gives value and is without notice of the conversion. In his suit against Able, Donald will invoke the maker's duties under section 3-413(1)[9] and will seek to enforce them by use of the Article 3 recovery norm, section 3-307(2):

> When signatures are admitted or established, production of the instrument entitles a *holder* to recover on it unless the defendant [the maker] establishes a defense[10] (emphasis added).

As this section demonstrates, holder status is a necessary element in Donald's case.[11]

The Code contains two provisions relevant to the acquisition of holder status as regards negotiable instruments. The definition of

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[7] See White, supra note 1, at 1316-29.

[8] For a discussion of the problems arising from the theft of such instruments, see White, supra note 1, at 1317; Comment, supra note 1, 19 Okla. L. Rev. 179, 180 (1966); Miller v. Race, 97 Eng. Rep. 398 (K.B. 1758).

[9] See U.C.C. § 3-413(1): "The maker . . . engages that he will pay the instrument according to its tenor at the time of his engagement . . . ."

[10] Although U.C.C. § 3-307(2) is generally deemed to be a procedural norm, it is possible to view it as the counterpart to § 2-703 (seller's remedies) and § 2-711 (buyer's remedies) in the same sense that § 3-413 (contract of maker, drawer and acceptor) and § 3-414 (contract of indorser) are the counterparts of § 2-301 (general obligations of buyer and seller). Quite apart from procedural problems, it is often useful to distinguish between norms which set forth obligations and those which set forth the prerequisites for breach of those obligations.

[11] See U.C.C. § 3-307, Comment 2.

holder in section 1-201(20) applies primarily to determine the holder status of the first transferee of the instrument:

> Holder means a person who is in possession of . . . an instrument . . . drawn, issued or indorsed to him or to his order or to bearer or in blank.

In contrast, section 3-202(1) provides an alternative means to establish the holder status of a subsequent transferee:

> Negotiation is the transfer of an instrument in such a form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement; if payable to bearer it is negotiated by delivery.

Recovery on the bearer note poses no problems with respect to the holder element.[12] Donald qualifies as a holder under section 1-201(20) because he is in possession of a note drawn to bearer. He also qualifies under section 3-202(1) since bearer paper is negotiated by delivery and since negotiation converts the transferee into a holder. Whether or not Donald also becomes the "owner" of the note is irrelevant, for any residual ownership claims will be severed when Donald's holder status is combined with his good faith, lack of notice, and having parted with value.[13]

Recovery on the second note is more troublesome.[14] That note was payable to the order of Baker who stole the instrument from the maker, Able. Once again, Donald must satisfy the holder requirement of section 3-307(2) in order to recover. In the case of order paper, Donald's holder status depends upon Baker's subsequent indorsement. Under the section 1-201(20) definition of holder, however, Donald must demonstrate that he is in possession of an instrument *indorsed* to his order or in blank. Similarly, section 3-202(1) affords holder status as a result of negotiation that also depends upon indorsement.[15] Not surprisingly, the question unavoidably arises as to whether Baker's signature constitutes an indorsement for purposes of those two sections.

It is at this point that Baker's own status as a holder becomes

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[12] Because § 3-207(2) gives to the maker the right of rescission of negotiation except against subsequent holders in due course, it is crucial for the transferee to become a holder in due course in order to sever the residual claims of the owner, Able.

[13] See U.C.C. § 3-305(1).

[14] See discussion in White, supra note 1, at 1318-28; Comment, 19 Okla. L. Rev. supra note 1, at 181.

[15] U.C.C. § 3-202(1): "Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement. . . ."

seemingly relevant in light of section 3-202(2), which provides that "an indorsement must be written by or on behalf of the holder . . . ." With some hesitation, commentators, including Professor White, have interpreted this provision to be the definition of indorsement.[16] They argue that unless Baker was a holder there can be no valid indorsement for purposes of sections 1-201(20) and 3-202(1), which determine Donald's holder status.[17] They are thus led, ineluctably, into a debate over whether a thief can be a holder.

The holder status of the thief (Baker) must, as described above, be derived from one or both of the Code's holder provisions, Sections 1-201(20) and 3-202(1). In the case of either bearer or order paper, Baker cannot acquire holder status pursuant to section 3-202(1). By virtue of its reference to negotiation, that provision applies only to the status of transferees subsequent to the issuance of the instrument. Even if section 3-202(1) applied to the original acquisition of an instrument, it would still not operate to confer holder status upon Baker since the note was not delivered to him. For negotiation purposes "delivery," as defined in section 1-201(14), is the "voluntary transfer of possession."[18] Baker's status under the general holder definition in section 1-201(20) is less clear; he is required to be in possession of an instrument "drawn, issued or indorsed to him or to his order." The term "drawn" is said to refer only to checks;[19] Baker's lack of holder status also makes "indorsed" inapplicable in the present context. Therefore, Baker's holder status seemingly depends upon the meaning of the term "issued." However, under section 3-102(1)(a), "issue" includes the element of delivery to a holder. This interpretation produces a somewhat anomalous result.[20] In our case Baker would be denied "holder" status since the terms "drawn" and "indorsed" do not describe his mode of acquisition of the note and since the term "issued" presupposes an element of voluntariness. On the other hand, if the instrument in question were a check[21] payable to Baker, the latter would qualify as a holder since "drawn" does not presuppose delivery and would accurately describe his mode of acquisition.

The problems raised by an instrument in the form of a note pay-

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16 See, e.g., White, supra note 1, at 1327; Mellinkoff, supra note 1, at 192; Palizzi, supra note 1, at 666.

17 See White, supra note 1, at 1327.

18 In the case of bearer paper, Donald may still be a "holder" even though Baker is not. Baker can "deliver" the instrument to Donald and § 3-202 only requires "delivery" as a prerequisite to conferring holder status on the transferee.

19 See White, supra note 1, at 1318.

20 Id.

21 Under the Uniform Negotiable Instruments Law [hereinafter cited as NIL], the definition of "holder" precluded this particular anomaly: NIL § 191: "Holder means the payee or indorsee of a bill or note who is in possession of it, or the bearer thereof."

able to the thief's order may result not from any looseness in drafting but rather from infirmities in interpretation. For instance, it is doubtful whether the terms "issued" and "drawn" as used in section 1-201(20) were meant to distinguish between a note thief and a check thief. Although the Code may elsewhere distinguish between "drawing" and "making" and between "drawers" and "makers,"[22] this does not force one to conclude that "drawn" in Section 1-201(20) refers only to checks. The terms "drawn" and "made" are frequently used interchangeably to describe the composition of instruments.[23] Hence, in the interest of achieving consistent results in the stolen check and stolen note cases, the term "drawn" can be extended without difficulty to include notes in the context of section 1-201(20), and thereby to confer "holder" status upon the thief.[24]

The proper construction of section 1-201(20) is, however, a minor point.[25] The far more intriguing question is whether the status of the thief (Baker) is even material to Donald's claim on the second instrument. The status of Baker becomes important as the result of the following line of argument:[26] Donald must, to recover under section 3-307(2), show that he is a holder; with respect to the second instrument Donald's status as a holder, whether under section 3-202(1) or section 1-201(20), depends upon Baker's indorsement; under section 3-202(2) an indorsement can only be made by a holder; therefore, the status of the thief (Baker) must be examined.

The crucial link in this argument is the interpretation of section 3-202(2):

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[22] For U.C.C. provisions which establish different substantive obligations for drawers and makers, see, e.g., §§ 3-122, 3-413. Article 3 is replete with instances where "drawing" and "making" are used in connection with checks and notes respectively; see also U.C.C. §§ 3-112(1)(g), 3-118(a), 3-121 (Alternative A), 3-122(3), 3-413(2), 3-412(1), 3-501(1)(c).

[23] U.C.C. §§ 3-205, Comment 1; 3-406, Comment 2; 3-115, 3-117, Comment 1; 3-201, Comment 3; and NIL § 8.

[24] The Code elsewhere recognizes that a thief may qualify as a holder. U.C.C. § 3-603(1)(a): "This subsection [dealing with discharge by payment to a holder] does not, however, result in the discharge of the liability (a) of a party who in bad faith pays or satisfies a *holder who acquired the instrument by theft*. . ." (emphasis added). It has been argued that § 3-305(1) implicitly requires that holder status be attributed to a thief. Under that section, some holders (those in due course) can take free of ownership claims attached to the instrument; this would not be possible if delivery were an element of holder status. See White, supra note 1, at 1318, 1321-22.

[25] The term "issued", although referred to in § 1-201(20), raises more problems than it answers and thus is probably irrelevant to the discussion of Baker's holder status. As a matter of common usage in the Code, "issue" refers primarily to documents of title and investment securities, both of which are also mentioned in § 1-201(20). Furthermore, since the Article 3 definition of "issue," contained in § 3-102(1)(a), presupposes the notion of "holder," it is senseless to employ the former term to discriminate between the relative abilities of note thieves and check thieves to engender "holder" status in their transferees.

[26] See White, supra note 1, at 1317-19, 1326-28.

> An indorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof.

This section establishes, at the very least, two necessary prerequisites for a valid indorsement:[27] (1) it must be in writing and (2) it must appear on the instrument or be affixed thereto. In the absence of either, there can be no indorsement. The normative meaning of the remaining language—"by or on behalf of the holder"—is less clear.

Commentators have interpreted the phrase, "by or on behalf of the holder," as conditioning the validity of an indorsement upon the holder status of the purported indorser.[28] This construction would be more plausible if the phrase were "by or on behalf of *a* holder." As presently worded, section 3-202(2) does not require the indorsement to be made by a holder; rather, it merely presupposes that the instrument is in the possession of a holder. This construction limits the imperative ("must") aspect of the section: it says nothing more than that if there is a holder, then the indorsement *must* be made by him or on his behalf. Except by way of negative pregnant, the phrase implies nothing for the situation where the instrument is in the hands of a nonholder.

There is no judicial or secondary authority either accepting or rejecting this construction of section 3-202(2). In fact, the courts have just begun to discover the ambiguities latent in the provisions governing the creation and transfer of holder status.[29] However, the validity of the proposed construction need not rest on judicial authority alone. By way of justification, the proposed construction of section 3-202(2) can be shown to facilitate considerably the application of Article 3 in cases involving negotiable instrument frauds.

In negotiable instrument frauds, one crucial issue is whether the last transferee is a holder. As discussed above, a determination of a party's status as holder must always commence with section 1-201(20) and/or 3-202(1). Given this starting point, the direction and ease of further analysis is governed by one's interpretation of the indorsement requirements of section 3-202(2). Adoption of Professor White's interpretation—that indorsement by a nonholder is ineffective for the

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[27] These are the only two elements discussed in the Comments to U.C.C. § 3-202(2).

[28] See, e.g., White, supra note 1, at 1327; Mellinkoff, supra note 1, at 192; Palizzi, supra note 1, at 666.

[29] See Bowling Green, Inc. v. State Street Bank & Trust Co., 425 F.2d 81, 83-84 (1st Cir. 1970), aff'g 307 F. Supp. 648, 653-54 (D. Mass. 1969) (collecting bank as holder in the absence of depositor's indorsement); *Bowling Green*: The Bank As A Holder In Due Course, 71 Colum. L. Rev. 302, 308-11 (1971); Bryan v. Bartlett, 435 F.2d 28 (8th Cir. 1970) (receiver as holder); Estate of Kohlhepp v. Mason, 25 Utah 2d 155, 478 P.2d 339, (1970) (presentment by a nonholder under § 3-504(1)); Billingsley v. Kelly, 261 Md. 116, 274 A.2d 113 (Md. App. 1971) (constructive possession as sufficient for holder status under § 1-201(20)).

purpose of creating holder status in his transferee—necessitates an examination of the holder status of successively prior transferors. As a result, the holder status of the person who perpetrated the fraud must eventually be determined. His status as a holder controls the validity of the indorsement, which in turn controls the next transferee's holder status, and so forth down the line. However, sections 1-201(20) and 3-202(1) are difficult to apply with respect to impostors, false agents, individuals who negotiate in breach of a duty, and parties in possession of instruments payable to fictitious payees.[30]

The drafters of Article 3 obviously did not intend that the holder status of an impostor, for example, should be determinative of the holder status of the last transferee. Section 3-405(1)(a) makes effective the impostor's indorsement without regard to his status as a holder. The impostor provision is but one of a battery of "validation" provisions which cure defective indorsements without regard to the holder concept.[31]

In order to make these validation provisions operative in any given problem, it is necessary to reject Professor White's construction of section 3-202(2). His contention that indorsement by a nonholder is invalid makes holder status the sole determinative of the effectiveness of an indorsement. The presence of the numerous validation provisions suggests that this construction of section 3-202(2) ig-

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[30] Consider, for instance, the holder status of an impostor. As the initial transferor of the instrument he must acquire holder status, if at all, under § 1-201(20). Whether the instrument will be viewed as having been drawn to the impostor's order will depend upon whether the drawer's intention is deemed to be one of the aspects of drawing an instrument. Reflections on this problem led the NIL drafters to view such an instrument as bearer paper and led courts and commentators to distinguish between impostors who confronted their victims personally and those who operated through the mails. See W. Britton, Handbook of the Law of Bills and Notes §§ 140-46 (1st ed. 1943). The same problems arise with respect to fictitious payee paper. The U.C.C. circumvents the ambiguities latent in "drawing" and "order" by focusing strictly upon the effect of the impostor's indorsement; see § 3-405 and the accompanying Official Comments. Or consider the holder status of an agent who is authorized to negotiate instruments for his principal's account. One day he indorses an instrument to his own order and negotiates to a third party for his own account. Whether or not the faithless agent is a holder may depend upon the effect of his indorsement to his own order. If the signature is unauthorized, it is wholly inoperative; it will not enable the agent to attain holder status under § 1-201(20). However, since the authorized nature of the signature is, by force of § 1-201(43), made dependent upon questions of apparent and implied authority, there is considerable room for debate concerning the agent's holder status. The U.C.C. avoids these problems by focusing upon the transaction as a whole. Under § 3-207(1)(d), a negotiation in breach of duty is deemed effective.

[31] Other U.C.C. validation provisions are: § 3-207(1)(d) (negotiation in breach of duty is effective); § 3-406 (negligence precludes assertion of unauthorized signature); § 3-413(3) (by drawing the drawer admits existence of the payee); § 3-405(1)(b), (c) (indorsement in name of fictitious payee is effective); § 3-117 (an agent may, under certain circumstances, act as a holder); § 3-203 (instrument payable to person under misspelled or wrongly designated name may be indorsed in that name).

nores the fundamental interrelationship between the holder concept and the validation provisions. These provisions, not the holder in due course doctrine, should, and do, function as the proper analogue to the good faith purchaser doctrine which operates in connection with the transfer of personal property.[32] Any "definition" of holder status or its constituent elements must either make explicit reference to the validation provisions or at least be phrased as a negative implication so as to invite consideration and application of those provisions.

In order not to circumvent or short-circuit the applicability of the validation provisions, it is necessary to adopt the proposed construction of section 3-202(2): if the instrument is in the possession of a holder, then indorsement must be made by him or on his behalf; if the instrument is in the possession of a nonholder, then the nonholder's indorsement will be invalid only in the absence of an applicable curative validation provision. Construed in this fashion, section 3-202(2) requires that the initial consideration be not the holder status of the perpetrator of the fraud, but rather, the applicability of one or more of the validation provisions. If there is no apposite validation section, then, and only then, may the negative implication of section 3-202(2)—that indorsement by a nonholder is invalid—be deemed dispositive.

Not suprisingly, Article 3 contains a norm which, under the here hypothesized circumstances, may preclude reliance upon the negative implication of section 3-202(2). That norm is found in section 3-207 (1)(d): "Negotiation is effective to transfer the instrument although the negotiation is . . . made in breach of duty." Since Baker acquired the instruments by theft, Able has a right to reclaim and Baker is under a duty to return them.[33] Baker's release of possession and purported indorsement to Donald constitute a breach of this duty.

Under section 3-207(1)(d) such a purported negotiation is, without qualification, deemed effective. Under section 3-202(1) negotiation is sufficient to make Donald a holder. Whether or not section 3-207 (1)(d) also specifically validates Baker's indorsement is beside the point. That section validates the entire negotiation without regard to the validity of its constituent elements. The validated negotiation

[32] Like U.C.C. § 2-403, which recognizes that a "person with voidable title has power to transfer a good title to a good faith purchaser for value," the validation provisions were conceived to cure title defects. The holder in due course doctrine, in contrast, presupposes an absence of title defects. It operates mainly to cut off defenses rather than claims.

[33] It is this right and corresponding duty which form the basis for the action of conversion; see Restatement (Second) of Torts § 222A(1) (1965). There is nothing explicit in either U.C.C. § 3-207 or its accompanying Comments to indicate that "breach of duty" was meant (or not meant) to cover Baker's actions. However, Comments 2 and 3 do refer to negotiation by a thief. Although it is not specifically directed at any particular subsection, that reference seems inappropriate in connection with any but the "breach of duty" subsection.

endows the transferee with holder status. The Comments to section 3-207 leave no doubt that the drafters intended the provision to encompass attempted negotiations by a thief.[34] Indeed, the language of the Official Comment goes far beyond the herein proposed approach to holder status. The Comment states: "It is inherent in the character of negotiable paper that any person in possession of an instrument which by its terms runs to him is a holder, and that anyone may deal with him as a holder." Were that sentence the law, then regularity and possession would be the sole prerequisites for holder status. Where those two elements are present, as they are in the two notes described at the outset of this section, there would be no necessity to analyze the holder status of prior transferees.

Although the Official Comment probably represents an overstatement or oversimplification, it does militate against any construction of section 3-202(2) which would make the holder status of a prior transferee solely dispositive of the holder status of subsequent transferees. The purport of the Comment, as well as the presence of the validation provisions, indicates that in the case of either bearer or order paper the holder status of the subsequent transferees does not invariably depend upon the holder status of their predecessors. Indeed, the breadth of the validation provisions suggested by section 3-207(1)(d) and the Official Comment discloses a strong policy in favor of viewing possession and regularity as the sole constituents of holder status. A comprehensive examination of the cases involving negotiable instrument frauds would perhaps reveal that most final transferees will be able to claim holder status on the basis of regularity and possession because of the number and breadth of the validation provisions. Professor White's approach to section 3-202(2)—far from representing the law governing defective indorsements—may be so limited by the validation provisions that it should be viewed as an exception to the rule that possession and regularity are enough to create holder status.

The practical consequences of the proposed construction perhaps best demonstrate its benefits. Section 3-207(1)(d) and the accompanying Comments not only appear to obviate the need to predicate Donald's holder status upon the holder status of his indorser (Baker the thief), but also seem to avoid the definitional problems posed by sections

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[34] U.C.C. § 3-207, Comment 2 states, in part:

> It is inherent in the character of negotiable paper that any person in possession of an instrument which by its terms runs to him is a holder, and that anyone may deal with him as a holder. The principle finds its most extreme application in the well settled rule that a holder in due course may take the paper even from a thief and be protected against the claim of the rightful owner.

See also §§ 3-603(1)(a) and 3-305, discussed supra at note 24, which recognize that thieves may enjoy holder status. For a discussion of "delivery" as a prerequisite for the existence of the maker's or drawer's contract, see W. Britton, supra note 30, at § 50.

1-201(20) and 3-202. Moreover, reference to this section produces what is generally acknowledged to be the most proper allocation of loss: with respect to the first and second instruments, Donald acquires holder status and may invoke all the advantages incident thereto.[35] The first instrument, it will be remembered, was a bearer note. Like cash, such paper contains no signature chain which enables a would-be purchaser to discover defects in title. The purchaser relies solely upon the promise of the maker, who should not be heard to invoke the very title defects which he helped make possible. The second instrument was payable to the order of the eventual thief. Theft of such instruments will probably occur in the context of employment or other on-going relationship between the maker and thief-payee.[36] In these situations the maker is in a position to prevent and detect such fraud. Requiring the maker to suffer the loss under such circumstances conforms with the policy of the Code which consistently precludes the drawer or maker from invoking his employee's dishonesty to the detriment of subsequent good faith purchasers of the instrument.[37]

Finally, it never seemed quite appropriate to make the thief's (Baker's) holder status determinative of Donald's holder status on the first and second instruments. The significance of holder status lies primarily in the fact that it provides a basis for reliance by third parties who deal with the possessor of the instrument.[38] In many instances, the third party will be a court whose reliance on the status of the holder will result in procedural advantage to the holder.[39] In other situations, a third-party transferee or discharger benefits from the legitimizing effect that the holder status of the transferor has on certain of his acts.[40] The definition of holder must be formulated in light of these purposes.

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[35] See, e.g., U.C.C. §§ 3-301 (right to transfer, negotiate, discharge, or enforce); 3-302 (ability to qualify as holder in due course); 3-307(2) (procedural advantages); 3-603(1) (sentence 1) (discharge effect of payment to holder).

[36] See, e.g., O.P. Ganjo, Inc. v. Tri-Urban Realty Co., 108 N.J. Super. 517, 261 A.2d 722 (L. Div. 1970) (subcontractor stole note payable to his order from desk of contractor and parties conceded that subsequent purchaser was holder in due course); Pavilis v. Farmers Union Livestock Comm'n, 68 S.D. 96, 298 N.W. 732 (1941) (employee steals blank but signed payroll checks); Sheffer v. Fleischer, 158 Mich. 270, 122 N.W. 543 (1909) (seller steals buyer's notes payable to seller while seller waits on another customer); Salley v. Terrill, 95 Me. 553, 50 A. 896 (1901) (employee steals wage check payable to himself); Dodd v. Dunne, 71 Wis. 578, 37 N.W. 430 (1888) (in the process of closing a land deal, seller's attorney steals a commission note payable to self).

[37] See, e.g., U.C.C. §§ 3-405(1)(c) (padded payroll provision); 3-406 and Comment 7; 3-407, Comment 3(a) (alteration by agent).

[38] The reliance principle is most clearly articulated in U.C.C. § 3-207, Comment 2 (sentence 1) quoted in note 34 supra.

[39] See U.C.C. § 3-307(2) and Comment 2 which permit a holder, when a signature is admitted or established, to recover on the instrument. For a detailed consideration of this point see Kinyon, supra note 5, at 1447-554.

[40] Under U.C.C. § 3-201 the "holder" status of a party legitimizes transfer, negotiation, discharge and enforcement.

The definition should set forth those factors deemed socially sufficient to justify reliance by third parties. Among these factors, one necessary element should be possession of the instrument. Another must be regularity, *i.e.*, that the words of the instrument are not inconsistent with the possession. These two requirements are clearly included in both the U.C.C. and NIL definitions of holder.[41]

The crucial question is whether possession and regularity are sufficient.[42] If, as the Code seems to indicate, the significance of holder status should be directed at forming a basis for third-party reliance, then possession and regularity should suffice.[43] In particular, as regards the first and second notes, the status of the immediately prior deliverer (Baker) is irrelevant: his status as holder or nonholder is generally unascertainable by the would-be transferee (Donald), discharger or enforcer and, therefore, is not material to the issue of reliance.[44] In short, the absence of a logical connection between the prior party's holder status and the function served by the holder concept within the framework of Article 3 graphically indicates that Baker's status as a thief should not control Donald's status.

II. Effects of Conversion Upon the Holder Status of Subsequent Transferees of Instruments Carrying Forged Indorsements

At this point it might be argued that the proposed construction of section 3-207(1)(d) would operate to confer holder status upon Donald in a third situation: where Baker steals an instrument payable to Charles, forges Charles' indorsement, and negotiates it to Donald. These acts certainly constitute a breach of duty. Without more, section 3-207(1)(d) would imply that this attempted negotiation is also effective. However, a specific provision precludes reliance upon section 3-207. Section 3-404(1) provides that:

> Any authorized signature is wholly inoperative as that of the person whose name is signed . . . but it operates as the signature of the unauthorized signer . . . .

This norm requires that the name indorsed upon the third note be

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41 U.C.C. § 1-201(20): "'Holder' means a person who is in possession of . . . [an instrument] drawn, issued or indorsed to him or to his order or to bearer or in blank." NIL § 191: "'Holder' means the payee or indorsee of a bill or note, who is in possession of it, or the bearer thereof."

42 See W. Britton, supra note 30, at § 50 (delivery as condition precedent to existence of the instrument contract). See also NIL § 16: "Every contract on a negotiable instrument is incomplete and revocable until delivery of the instrument for the purpose of giving effect thereto."

43 This appears to accord with the intent of the Code's drafters; see U.C.C. § 3-207, Comment 2, quoted at note 34 supra.

44 Cf. W. Britton, supra note 30, at §§ 50-57.

viewed not as that of Charles but as that of Baker.[45] As a result, the instrument is not treated as being regular on its face.[46] If the third instrument were indorsed in fact with the name of Baker, there would be no reason to recognize any reliance interests on the part of Donald or his transferees; they should and would be denied advantages incident to holder status.

However, the instrument is not indorsed with Baker's name but rather with the purported signature of the payee, Charles. Under such circumstances, there exists a distinct tension between sections 3-404 and 3-207(1)(d). Indeed, without reference to the traditional law of negotiable instruments, there is no way to determine which of the two provisions is meant to govern the holder status of the transferee of the third instrument.[47] Regardless of whether the problem is viewed in terms of the transferee's reliance interests or the maker's culpability and expectation, there is no reason to distinguish between the transferee's holder status on a note stolen by the payee and one on which the thief forges the payee's name.[48] A forged indorsement does lend the appearance of regularity to the third instrument, and when the appearance of regularity is coupled with the thief's possession, the transferee's reliance is certainly justified.[49] Where the forger's transferee (Donald) negotiates the instrument to a good faith purchaser, these considerations apply with even greater force. The imputed culpability of the maker with respect to the forged instrument is not noticeably less than it is in the case of the invalidly indorsed second instrument. Instruments of either type frequently enter into circulation through the dishonesty of an embezzling employee.[50]

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[45] See U.C.C. § 3-404, Comment 2.

[46] The term "regular" refers to the fact that the instrument, by its terms, runs to the party in possession thereof. Regularity is a key element in determining holder status under the Code. See U.C.C. § 3-207, Comment 2, and text supra at note 34 et seq.

[47] On the one hand, U.C.C. § 3-404 (inoperativeness of unauthorized signature) when read in conjunction with § 3-202(1) (indorsement as necessary element of negotiation; negotiation as sufficient to create holder status) prevents a transferee from becoming a holder over a forged indorsement. On the other hand, § 3-207(1)(d) (a negotiation is effective although made in breach of duty—a thief who attempts to negotiate by way of delivery and a forged indorsement has certainly breached a duty in respect to the payee) when read in conjunction with § 3-202(1) appears to validate the negotiation and thus confer holder status on the transferee. This appears to be one of those situations where "[i]n order to understand the UCC . . . you must first know the law of negotiable instruments." Mellinkoff, supra note 1, at 192.

[48] The second instrument, it will be recalled, was a note payable to Baker and stolen by the payee; the third was a note payable to Charles and stolen by Baker.

[49] See U.C.C. § 3-207, Comment 2.

[50] Compare the identity of parties who steal instruments of the second type (see cases cited and summarized supra note 36) with the identity of parties who wrongfully indorse and negotiate instruments of the third type in Prudential Ins. Co. of America v. Marine Nat'l Exch. Bank, 315 F. Supp. 520 (E.D. Wis. 1970) (forger unidentified); Salsman v. Nat'l Community Bank, 102 N.J. Super. 482, 246 A.2d 162 (1968) aff'd

Nor can these compelling arguments be vitiated by contending that the loss should be shifted onto the party who failed to know his indorser,[51] or that the maker has the right to receive the payee's indorsement.[52] Donald's request for identification from Baker would not have revealed the defects in the transferor's title. With respect to the instrument stolen by the payee, an identification inquiry would have revealed only that the payee was indeed the presenting party. With respect to the instrument on which the indorsement is forged, an identification query would have been equally unavailing; the thief (Baker) would have forged the payee's name either in blank or would have forged a special indorsement by the payee to the order of Baker. In either case, Baker comes to Donald with paper which is not only regular on its face but whose defective indorsement cannot be discovered by a routine request for Baker's identification.

The common law approach to unauthorized indorsements occasionally appears in the form of the altogether conclusory statement that the maker has the "right" to receive the payee's indorsement.[53] The Code version of this rule is, in effect, Professor White's interpretation of Section 3-202(2): indorsement by a nonholder is ineffective to endow the indorsee with holder status.[54] Whatever the merits of this interpretation, the Code elsewhere reduces the maker's right to a mere expectation, if not to an evanescent fiction. The Code's validation provisions—pursuant to which an unauthorized signature is declared effective—are undisguised qualifications upon this "right."[55] So numerous and broad are these exceptions to the purported rule that the effect

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without opinion, 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969) (unauthorized signature by payee's agent); Commercial Credit Corp. v. Citizens Nat'l Bank, 150 W. Va. 196, 144 S.E.2d 784 (1965) (indorsement forged by maker's agent); Allied Concord Financial Corp. v. Bank of America, Nat'l T. & S. Ass'n, 275 C.A.2d 1, 80 Cal. Rptr. 622 (Dist. Ct. App. 1969) (indorsement forged by payee's brother); Commonwealth v. Nat'l Bank & Trust Co., 46 Pa. D. & C.2d 141, 6 U.C.C. Rep. 369 (Ct. C.P. Dauphin County 1968) (indorsement forged by maker's employee); Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962) (indorsement forged by maker's agent); Starkey Constr., Inc. v. Elcon, Inc., 248 Ark. S.C.O. 958, 7 U.C.C. Rep. 923 (1970) (indorsement forged by co-payee); Thompson Maple Products, Inc. v. Citizens Nat'l Bank, 211 Pa. Super. 42, 234 A.2d 32 (1967) (indorsement forged by trusted friend and former employee of maker).

[51] Probably the most famous expression of this viewpoint appears in Mead v. Young, 4 T.R. 28 (K.B. 1790) (indorsement forged by person with same name as payee).

[52] This consideration is used to distinguish the "impostor" cases from the "false agency" cases; see Franklin Nat'l Bank v. Shapiro, 7 U.C.C. Rep. 317, 321 (N.Y. Sup. Ct., Nassau County 1970); cf. W. Britton, supra note 30, at § 147.

[53] See, e.g., U.C.C. § 3-405, Comment 2.

[54] This construction of U.C.C. § 3-202(2) produces the same results as the approach which gives the maker a right to the payee's indorsement. Any indorsement other than one by the payee is unauthorized and thereby incapable of creating holder status in subsequent transferees. Without holder status, the last transferee will be as completely barred from recovery as if the maker had a "right to the payee's indorsement."

[55] These validation provisions are set forth at note 32 supra.

of any given fraudulent indorsement will, as likely as not, be governed by one of the validation provisions as by the rule itself.[56] Under such circumstances, it is equally sensible to state the law's approach to unauthorized indorsements in terms of the "exceptions" to the rule. The law governing unauthorized indorsements may be characterized, not by the maker's right to his payee's indorsement, but rather by the payment claim of a party in possession of a regular instrument.[57]

III. The Holder Concept and the Risk of Alteration

A third conundrum involving the holder concept arises in connection with altered instruments.[58] Consider first a simple three-party situation: Able draws an instrument payable to bearer, Baker steals and raises the instrument from ten to ten thousand dollars and delivers it to Donald. Alternatively, Able draws an instrument payable to the order of Baker; Baker steals, raises, indorses in blank, and then delivers to Donald. If Donald is a holder in due course, he can enforce both instruments against Able according to their original tenor.[59] In case of an incomplete instrument,[60] or in case of negligence on Able's part,[61] Donald may be able to enforce the instrument according to its altered tenor. Furthermore, under section 3-207(1)(d) Donald's

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[56] See, e.g., Comment, Forgeries and Material Alterations: Allocation of Risks Under the Uniform Commercial Code, 50 B.U.L. Rev. 536, 543-51 (1971), in which one author concludes that U.C.C. validation provisions (e.g., §§ 3-404, 3-405, 3-406, 3-407, and 4-406) place considerably more risk on the drawer than pre-U.C.C. law.

[57] This characterization resembles the position adopted by the Geneva Bills of Exchange Act [art. 16(2)] and Geneva Check Act [art. 21]. For an excellent comparison of the domestic and continental laws of negotiable instruments, see Kessler, Forged Indorsements, 47 Yale L.J. 863 (1938).

[58] Cf. White, Some Petty Complaints About Article Three, 65 Mich. L. Rev. 1315, 1324 (1967); R. Speidel, R. Summers & J. White, Commercial Transactions Teaching Materials 1063 (1969); Comment, Commercial Transactions: Can a Thief Be a "Holder"? 19 Okla. L. Rev. 179, 181 (1966).

[59] U.C.C. § 3-407(3): "A subsequent holder in due course may in all cases enforce the instrument according to its original tenor, and when an incomplete instrument has been completed, he may enforce it as completed."

[60] See U.C.C. § 3-407(3); Herdman v. First Nat'l City Bank, 3 U.C.C. Rep. 628 (N.Y. Sup. Ct., N.Y. County 1966) (drawer signed check but left payee's name blank; thereafter check stolen, made payable to cash, and paid by defendant bank); Waterburg Savings Bank v. Jaroszewski, 4 Conn. Cir. Ct. 620, 238 A.2d 446 (1967) (plaintiff financing bank not defeated by fact that consumer note given by defendant buyer to seller was incomplete and completed by seller).

[61] U.C.C. § 3-406. See Comment, supra note 56, at 547-49. For recent applications of this section see Brower v. Franklin Nat'l Bank, 311 F. Supp. 675 (S.D.N.Y. 1970); Sam Goody, Inc. v. Franklin Nat'l Bank, 57 Misc. 2d 193, 291 N.Y.S.2d 429 (N.Y. Sup. Ct., Nassau County 1968); Wallach Sons, Inc. v. Bankers Trust Co., 307 N.Y.S.2d 297, (Civ. Ct., N.Y. County 1970). All three cases deal with acceptor banks' liability to good faith holder of check raised after certification. In *Sam Goody* and *Wallach Sons*, the courts find that § 3-413(1) ("acceptor engages to pay . . . according to tenor at time of engagement") is dispositive in bank's favor. In *Brower*, the court invokes the possible applicability of § 3-406 to deny the bank's motion for summary judgment.

qualification as a holder in due course (in particular, his status as a holder) is not necessarily affected by Baker's status as thief or converter.[62]

In this three-party situation, the holder status of the altering party only becomes important if and when Donald does not qualify as a holder in due course. In the latter event, Able's liability must then be determined pursuant to section 3-407(2):

> As against any person other than a subsequent holder in due course (a) alteration by the holder which is both fraudulent and material discharges any party whose contract is thereby changed. . . .

Commentators have construed this section to mean that alteration by a nonholder will preclude the discharge effect of section 3-407(2)(a).[63] They then invite participation in the vexing game of attempting to determine whether Baker is a holder. They emphasize that it is desirable to view the thief as a nonholder in order to prevent discharge and eventual unjust enrichment of Able.[64] They, however, bemoan the resulting contradiction: in connection with stolen, but unaltered, instruments it is desirable to view the thieves as holders because of indorsement problems, while, conversely, it is necessary to view the thieves as nonholders with respect to stolen and unaltered instruments.[65] The dilemma is accentuated by the fact that the Code seemingly acknowledges the possibility that a thief may be a holder.[66]

One horn of this dilemma was removed in the foregoing discussion which concluded that, with respect to certain stolen and unaltered instruments, Donald's rights in no way depend upon the thief's status as a holder.[67] The problem raised by the other horn of the dilemma does require more consideration. This problem concerns the construction of section 3-407(2). Thus, even if one grants the correctness of the current construction of section 3-407(2)—that alteration by a nonholder precludes the discharge effect—it does not follow that, at least in the simple three-party situation, it is desirable to view the

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[62] See text at notes 31-43 supra.

[63] See White, supra note 58, at 1324; R. Speidel, R. Summers & J. White, Teaching Notes 169 (1969); Comment, supra note 58, at 181.

[64] See, e.g., White, supra note 58, at 1325-26. The unjust enrichment occurs when Able is discharged not only from his liability as maker under U.C.C. § 3-413(1) but, eventually, also from his liability on the underlying transaction pursuant to § 3-802(1)(b) ("discharge of the underlying obligor on the instrument also discharges him on the obligation").

[65] See White, supra note 58, at 1325-26.

[66] U.C.C. § 3-603(1), as well as § 3-207, Comment 2, expressly recognizes that a thief may be a holder, while in § 3-305, there is an implied recognition of the same possibility. See note 24 supra.

[67] With respect to § 3-207(1)(d) see text at notes 34-43 supra.

thief as a nonholder. Furthermore, the current construction of section 3-407(2) appears even more untenable once the analysis shifts to four-party situations.[68]

The effects of alteration in the three-party context become crucial primarily in the absence of a holder in due course.[69] Assume, for example, that Donald does not qualify as holder in due course because he had "reason to know"[70] that the instrument had been altered.[71] Under these circumstances, Baker's status as a holder seemingly determines whether or not Able remains liable to Donald for the original amount.[72] If Baker is deemed a holder, section 3-407(2)(a) completely discharges Able from any liability on the instrument. If, on the other hand, Baker is deemed a nonholder, section 3-407(2)(b) applies and the instrument may be enforced according to its original tenor.

In the absence of a purported negotiation under section 3-202(1) Baker's status as a holder must be decided under section 1-201(20). Although the latter section is somewhat ambiguous as applied to thieves of bearer paper or paper payable to the thief, the most reasonable interpretation results in the conferral of holder status on Baker.[73] As regards the present problem under section 3-407(2), this interpretation throws the loss onto Donald. Able is completely discharged on the instrument. Nor is this result manifestly undesirable in light of the fact that Donald has notice of the alteration.

The prevailing argument[74] against viewing the thief as a holder derives from the "spoliation" doctrine[75] which finds some support in the Official Comments to section 3-407:

> A material alteration does not discharge any party unless it is made by the holder. Spoliation by any meddling stranger does not affect the rights of the holder.[76]

The Comment, however, merely begs the issue: is the thief a holder

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[68] See text at notes 78-94 infra.

[69] See text at note 59 supra.

[70] U.C.C. § 1-201(25)(c).

[71] This is the most likely ground for denying holder in due course status because the special paper used in printing checks and other instruments is designed to give subsequent transferees' "visible evidence of alteration" in all but those instances in which the alteration is perpetrated by additional markings. U.C.C. § 3-304(1)(a).

[72] White, supra note 58, at 1324-26.

[73] The ambiguity stems from the different meanings of "drawn" and "issued" and the applicability of these terms to notes and checks. See text at notes 19-24 supra.

[74] See White, supra note 58, at 1324 n.31.

[75] For a general discussion of the "spoliation" doctrine, see W. Britton, Handbook of the Law of Bills and Notes § 280 (1st ed. 1943). Apparently there have been no "spoliation" cases decided under the U.C.C. Like the U.C.C., the NIL (§ 124) made no explicit reference to the "spoliation" exception to the general rule governing the effects of alteration.

[76] U.C.C. § 3-407, Comment 3(a).

or a meddling stranger? To answer this question, one can look either to the Code or to the case law arising under the spoliation doctrine. If it is true that certain Code provisions grant holder status to thieves, the result would be that Able is discharged on the note.[77] Fortunately, this tentative conclusion is not at odds with the traditional spoliation doctrine.

Research of the spoliation cases reveals that they involve variations upon the following factual situation: X draws an instrument to the order of Y and then delivers the instrument to Y in exchange for a benefit (goods, money). When Y comes to enforce the instrument, X discovers that it has been materially altered. The alteration is generally attributed to an unknown party[78] or to unauthorized conduct on the part of a servant of X[79] or Y.[80] X seeks to invoke the rule that any such alteration discharges a party on the instrument whose contract is thereby changed. This rule makes applicable the further rule that discharge on the instrument entails discharge on the underlying obligation.[81] Motivated by the possibility of unjust enrichment in favor of X,[82] the courts were quick to carve out the spoliation exception to the basic norm governing the effects of material alteration.[83]

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77 See text at notes 20-24 supra.

78 See Andrews v. Calloway, 50 Ark. 358, 7 S.W. 449 (1888) (unknown party inserts words, "or bearer" in an originally non-negotiable note; held to be spoliation).

79 See Fullerton v. Sturges, 4 Ohio St. 530 (1855) (maker's financial agent, contrary to instruction, affixes seal to a note; held to be spoliation); Walsh v. Hunt, 120 Cal. 46, 52 P. 115 (1898) (maker executed a note and mortgage and employed an agent to sell the paper; the agent raised the note; in suit against maker, alteration held to be spoliation).

80 Hunt v. Gray, 35 N.J.L. 227 (1871) (payee's agent added words, "or discount," to note in order to make it acceptable to discounter; held to be spoliation); Presbury v. Michael, 33 Mo. 542 (1863) (payee's financial agent adds interest clause to note; held not to be spoliation in light of agent's authority).

81 U.C.C. § 3-802(1)(b): "Unless otherwise agreed where an instrument is taken for an underlying obligation . . . discharge of the underlying obligor on the instrument also discharges him on the obligation."

82 See Hunt v. Gray, 35 N.J.L. 227 (1871) where payee's agent added words "or discount" to the note in order to make it acceptable to the discounter:

> The defendant [buyer-maker] in this case asks this court to decide that he may keep the plaintiff's [seller-payee who first sold and then took up the note upon nonpayment] horse without paying anything for him, because the agent of the plaintiff, under an erroneous idea of his rights, made the alteration in question . . . . It is not often that a party can perpetrate a fraud by force of the generality of legal rules . . . ."

Id. at 234.

83 See Walsh v. Hunt, 120 Cal. 46, 52 P. 115 (1898):

> The general rule undoubtedly is . . . that any material alteration in the contract avoids it, even in the hands of innocent holders, and prevents recovery upon it to any extent . . . . [T]he rule does not apply in cases where the alteration is by a stranger to the contract . . . . [S]uch an act by a stranger, without the privity of the grantee or obligee, does not avoid the contract in its entirety . . . but amounts to a spoliation merely, which will not prevent a recovery upon the contract in accordance with its original terms, where those terms can be ascer-

The spoliation doctrine is irrelevant to the three-party situation where a thief alters bearer paper or paper drawn to his order. The maker has received nothing of value upon parting with the instrument; consequently, discharge will not enrich him unjustly. Moreover, since by hypothesis Donald lacks holder in due course status (the spoliation doctrine is only relevant under this assumption), the maker's discharge coincides with Donald's lack of a meritorious reliance interest. Finally, there is a good reason for viewing the spoliation doctrine as an agency problem: *i.e.*, to what extent may an obligee cite an agent's misconduct as a ground for discharge with respect to an obligation which he knowingly and willingly undertook.[84] So viewed, the spoliation doctrine has no application in a situation where the alteration is performed by an individual who cannot be described as agent of any party to the dispute. Since the doctrine contributes nothing to the proper interpretation of the word "holder" in the present situation, all that remains is the Code-oriented analysis which favors extending holder status to the thief.[85]

In the foregoing discussion, it was the presently prevailing construction of section 3-407 (that alteration by a nonholder precludes the discharge effect of 3-407(2)(a)) which made necessary an examination of the holder status of the thief.[86] In the simple three-party situation, the problems engendered by section 3-407(2)(a) proved to be manageable, leading to defensible results. However, once additional parties are introduced, the provisions of 3-407 become unwieldy and lead to inconsistencies.

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tained . . . . And an agent without authority is in this sense held to be a stranger to the transaction . . . .

Id. at 53, 52 P. at 117.

[84] The NIL provision (§ 124) governing alteration explicitly acknowledged the agency problem: "Where a negotiable instrument is materially altered without the *assent* of all parties liable thereon, it is avoided, except as against a party who has himself made, *authorized* or *assented* to the alteration, and subsequent indorsers" (emphasis added). Under the U.C.C. the effects of agency relationships upon the consequences of alteration are, in part, covered by § 3-406 and in part are taken for granted; see § 3-407, Comment 3(a) which delimits the notion of "meddling stranger" in terms of agency law. The case law on "spoliation" consists largely of attempts to expand or contract the agency relationships between the altering party and the parties to the note. In addition to cases cited supra in notes 79 and 80, see Ruby v. Talbott, 5 N.M. 251, 21 P. 72 (1889) (payee dissatisfied with form of note requests agent to procure new note from maker; instead, agent allows maker to alter the first note; spoliation doctrine held not applicable); and Bodine v. Berg, 82 N.J.L. 662, 82 A. 901 (N.J. Ct. Err. & A. 1912) (bank manager alters note payable to bank):

> [T]he question is whether, as to the nonconsenting obligor, the alteration by the general manager of the bank was so foreign to his authority as to excuse the bank from all responsibility in the matter, and to make the general manager a stranger to the transaction.

Id. at 666, 82 A. at 903.

[85] See text at notes 34-44 supra.

[86] See text at notes 63-66 supra.

Consider a typical four-party situation: Able draws an instrument payable to Baker and delivers it to Baker; the latter indorses to the order of Charles and delivers to Charles; Charles indorses in blank; the instrument is stolen by a thief who raises and delivers it to Donald. Assume, finally, that Donald gives values and acts in good faith without notice of the conversion or alteration. Regardless of the thief's status as a holder, Donald can enforce the instrument against Able, Baker, or Charles according to its original tenor.[87] Suppose that Donald enforces the instrument against Charles. Charles' recourse rights against Able (maker) and Baker (indorser) derive from the contracts of the latter two parties: in the absence of any discharge, both maker and prior indorser are liable to a subsequent indorser who takes the instrument up.[88] However, since Charles is a "prior" rather than a "subsequent" holder in due course, he is potentially subject to the discharge defense under section 3-407(2)(a).

Three solutions have been proposed. The first would construe the thief as a nonholder whose alteration produces no discharge effect pursuant to the current interpretation of section 3-407(2).[89] However, this proposal conflicts with the results in the simple three-party situation described above,[90] contradicts the Code's apparent grant of holder status to some thieves,[91] and is difficult to reconcile with the section 1-201(20) definition of holder as applied in cases involving stolen but unaltered instruments.[92]

A second solution, favored by Professor White, recognizes the holder status of the thief but would avoid the discharge effect of section 3-407(2)(a) on the basis of a subrogation theory.[93] Under section 3-603(2), upon payment by Charles and surrender of the instrument to him, Charles acquires the rights of a transferee.[94] Pursuant to section 3-201(1), "the transfer of an instrument vests in the transferee such rights as the transferor has therein." With respect to Able and Baker,

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87 U.C.C. § 3-407(3): "A subsequent holder in due course may in all cases enforce the instrument according to its original tenor . . . ."

88 U.C.C. §§ 3-413(1) (liability of maker) and 3-414(1) (indorser's liability).

89 Cf. White, Some Petty Complaints About Article Three, 65 Mich. L. Rev. 1315, 1324-25 (1967).

90 See text at notes 69-85 supra.

91 U.C.C. 3-603(1)(a) explicitly recognizes and § 3-305 implies that a thief may enjoy holder status; see discussion note 24 supra.

92 See text at notes 34-43 supra.

93 White, supra note 89, at 1325 n.32, favors this solution.

94 Under the U.C.C. this result must be derived by implication from § 3-603(2) ("Surrender of the instrument to [one who pays] gives him the rights of a transferee") in conjunction with § 3-414(1) ("every indorser engages that . . . he will pay the instrument . . . to any subsequent indorser who takes it up . . . ."). Compare the more explicit formulation in NIL § 124.

Charles would become a "subsequent holder in due course" and would thus avoid the discharge effect of section 3-407(2)(a).

However, this proposal succeeds in precluding discharge and unjust enrichment only in those cases where Donald qualifies as a subsequent holder in due course. Where Donald "has reason to know" of the alteration, the subrogation theory will impose his notice upon an indorser who takes up the instrument. The pre-alteration indorser who reacquires the instrument presumbly can, at the very least, invoke his former rights, *i.e.*, enforce those obligations of prior parties arising under sections 3-413 and 3-414.[95] However, these rights cannot, by definition, give him subsequent holder in due course status for the purpose of avoiding the discharge effect of section 3-407(2). Such status must be derived from a subsequent holder by way of subrogation. As a subrogee, the pre-alteration indorser who reacquires the instrument can attain no better position than that occupied by his subrogor.[96] Hence, if the subsequent holder had notice of the alteration and was, for that reason, precluded from the status of subsequent holder in due course, it is difficult to perceive how the prior indorser can acquire such holder status upon reacquisition of the instrument from that party.

It is, of course, probable that under such circumstances Donald will not succeed in obtaining payment from any indorser.[97] This ignores the fact that Charles may nevertheless want to enforce the section 3-413(1) and section 3-414(1) contracts of Able or Baker.[98] However, so long as the thief is deemed a holder, Charles faces a Hobson's choice of seeing Able and Baker discharged under section 3-407(2)(a), or inheriting Donald's notice under sections 3-603(2) and 3-201(1).[99] Moreover, discharge on the instrument arguably precludes recourse on the underlying obligation.[100] That obligation might be preserved by arguing that the instrument was not "taken *for*

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[95] This basic right of recourse is provided by U.C.C. § 3-413(2): "The drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft . . . to any indorser who takes it up" and by § 3-414(1): "every indorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument . . . to any subsequent indorser who takes it up."

[96] U.C.C. § 3-603(2) ("Surrender of the instrument to . . . [one who pays] gives him the rights of a transferee") in conjunction with § 3-201(1) ("transfer of an instrument vests in the transferee such rights as the transferor has therein") produces this result.

[97] Due to his knowledge of the alteration, Donald will not qualify as a holder in due course. U.C.C. §§ 3-302(1)(c), 3-304(1)(a).

[98] Presumably Charles has given value (e.g. goods) for the instrument in reliance upon the maker's contract and his recourse rights against prior indorsers.

[99] See notes 95-96 and text at note 88 supra.

[100] See U.C.C. § 3-802(1)(b)(sentence 2) which states, in part, that "discharge of the underlying obligor on the instrument also discharges him on the obligation."

[the] underlying obligation"[101] but was taken as security or mere evidence of the obligation (emphasis added). However, this tenuous argument provides an inadequate solution, insofar as it deprives Charles of the procedural advantages of suing on the instrument.[102] Alternatively, one can argue that the thief is a nonholder, but this contention again raises the very set of inconsistencies which should be avoided.[103]

A third proposal would have the courts solve the recourse problem in terms of the equitable doctrines of unjust enrichment and quasi-contract, which are preserved by section 1-103.[104] For example, discharge of Baker under section 3-407(2)(a) might, in light of section 3-802, prevent Charles from taking recourse against Baker on the underlying obligation.[105] However, there were no defects in either the underlying obligation or in the instrument taken by Charles; nor did the unenforceability of the obligation result from any culpability or laches on his behalf. Accordingly, by analogy to the treatment of benefits acquired under contracts subject to attack for illegality or noncompliance with the Statute of Frauds,[106] Charles should be able to recover at least the value of the goods or services transferred to Baker in exchange for the instrument. Indeed, the Code itself, by imposing an obligation of good faith in the performance and enforcement of every contract within the scope of Section 1-203, establishes the basis for a very similar argument. This good faith obligation should prevent Baker from invoking a discharge provision where the result would be to leave Baker in retention of the benefit acquired through the underlying sale or loan contract, even though the other party to the contract committed no act which would justify such an unfair result. Although workable, these suggestions should not be adopted until it is well established that the Code, designed to regulate commercial paper, does not indeed provide for the specific resolution of rather straightforward recourse problems.[107]

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[101] U.C.C. § 3-802(1). Cf. W. Britton, Handbook of the Law of Bills and Notes § 286 (1st ed. 1943).

[102] Cf. U.C.C. § 3-307(2) and Kinyon, Actions on Commercial Paper: Holder's Procedural Advantages Under Article Three, 65 Mich. L. Rev. 1441, 1452-56 (1967).

[103] See text at notes 89-92 supra.

[104] See Comment, supra note 58, at 181-82.

[105] U.C.C. § 3-802(1)(b): "[D]ischarge of the underlying obligor on the instrument also discharges him on the obligation."

[106] See Restatement of Restitution § 108(d) (1937); 2 A. Corbin, Contracts § 321 (1950).

[107] The U.C.C. drafters devoted considerable attention to recourse rights. For example, the Code explicitly regulates the rights of one who pays over a forged indorsement; under the prior law, this problem was dealt with in terms of restitution and unjust enrichment. Compare U.C.C. §§ 3-417(1), 4-207(1) with NIL § 65 and Restatement of Restitution § 35 (1937). See also U.C.C. § 3-417, Comment 1.

IV. Reinterpretation of Section 3-407(2)

The untoward effect of alteration upon recourse rights can be overcome by reevaluating the source of the difficulty: the reference to *holder* in section 3-407(2)(a). This section provides that "alteration by *the* holder . . . discharges any party whose contract is changed . . ." (emphasis added). Before the effect of the alteration defense can be assessed, one must first identify the referent of the term, "*the* holder." To avoid the rigors of circular definitions, identification should be made in the inviting context of a suit in which the plaintiff seeks to recover on the instrument.[108] Such a suit will be framed and prosecuted in accordance with section 3-307(2), which permits recovery upon the production of an instrument containing admitted or established signatures.[109] A prerequisite of that section is that the party seeking recovery be a holder. In the context of a recovery action based on Section 3-307 (2), the Code and judicial interpretations leave no doubt that the holder prerequisite requires the moving party to be in possession of the instrument.[110]

Once the plaintiff has established holder status and the other four elements of his case under section 3-307(2),[111] the burden shifts to the defendant on the last element of that provision, *i.e.*, the matter of defenses.[112] The defendant will then invoke the alteration defense under section 3-407(2). To succeed, the defendant must demonstrate the existence of an alteration by *the holder*. However, in the context of the recovery action under section 3-307(2), "holder" refers, if to anyone at all, to the plaintiff. Consistency alone would seemingly require that the correct referent for "holder" as used in section 3-407 (2)(a), should also be, if anyone, the plaintiff himself. On its face this suggestion is not too unreasonable. Holder status is a quality

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108 The possibility of becoming ensnared in circular definitions is well illustrated by E. Hirsch, Validity in Interpretation 76-78 (1967) and M. Cohen & E. Nagel, An Introduction to Logic and Scientific Method 223-43 (1934).

109 See Kinyon, supra note 102, at 1452-56.

110 U.C.C. § 3-307, Comment 2: "The provision [§ 3-307(2)] applies only to a holder, as defined in this Act (Section 1-201)." U.C.C. § 1-201(20) makes possession a necessary element of "holder" status. See also Rago v. Cosmopolitan Nat'l Bank, 89 Ill. App. 2d 12, 232 N.E.2d 88 (1967) where the court stated, in part: "the mere possession and production into evidence . . . entitles that holder to a prima facie basis for recovery . . . ." Id. at 19, 232 N.E.2d at 93.

111 U.C.C. § 3-307(2) may be broken up into six distinct elements: "When [1] signatures are [2] admitted or established, [3] production of [4] the instrument entitles [5] a holder to recover on it unless the defendant establishes [6] a defense" (emphasis added).

112 See U.C.C. § 3-307, Comment 2; Northside Bank v. Investors Acceptance Corp., 278 F. Supp. 191 (W.D. Pa. 1968); Factors and Note Buyers, Inc. v. Green Lane, Inc., 102 N.J. Super. 43, 245 A.2d 223 (L. Div. 1968).

whose main element is possession, and which, therefore, must follow the instrument.[113]

This proposed reinterpretation avoids all the inconsistencies engendered by the prevailing construction of section 3-407(2).[114] In the three-party situation, Able drew an instrument payable to bearer or to Baker's order and Baker proceeded to steal, raise, and negotiate the instrument to Donald. In the resulting suit by Donald against Able, the current construction of section 3-407(2) required that the holder status of the thief be determined as the effective basis for discharge, at least in those cases where Donald was not a subsequent holder in due course.[115] Certain Code provisions implied that Baker should be viewed as a holder.[116] Although this implication did sufficient justice to the interests involved and comported with other provisions of the Code, it did not follow ineluctably from the Code provisions defining holder.[117]

In contrast, the proposed interpretation leads immediately and unambiguously to the desired result. It permits Donald to repulse the section 3-407(2)(a) defense by merely pointing out that the alteration was not made by "*the* holder"—who, at the present time, is Donald himself—but rather by Baker who is no longer a holder. Consequently, Able's liability under the contract provisions of either section 3-414 or 3-413 remains alive. Recovery will depend not upon the sterile riddle of determining the thief's holder status, but upon whether Donald had sufficient notice.[118]

With respect to multi-party situations involving recourse liability, the proposed solution also avoids the problems engendered by the current construction of section 3-407(2).[119] Here Able drew an instrument payable to Baker and delivered it to him; Baker then indorsed the instrument specially and delivered it to Charles; Charles indorsed in blank, and a thief then stole the instrument and delivered it to

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[113] At any one point in time, only one person will qualify as the holder of the instrument. U.C.C. § 1-201(20). However, there exist a number of prior transferees who once enjoyed this status. Frequently, this prior status is significant in the Code; at other times, the drafters were concerned primarily with the party presently in possession of the instrument. Occasionally, this distinction is made explicit by use of the expressions, "a holder" and "the holder." Compare the meaning of "a holder" in §§ 3-202(1), 3-417(2) (preamble), 3-603(1), 3-604(1) with the purport of "the holder" in §§ 3-202(2), 3-301, 3-412(1), 3-413(2), 3-414(1), 3-501(1)(a), 3-506(1), 3-063(1), 3-604(2).

[114] See text at notes 88-107 supra.

[115] See text at notes 63-65 supra.

[116] See note 91 supra.

[117] Due primarily to ambiguities in the meanings of "drawn" and "issued" as used in U.C.C. § 1-201(20); see text at notes 19-24 supra.

[118] Donald will have to qualify as a subsequent holder in due course (U.C.C. § 3-407(3)) or prove negligence or ratification on the part of Able (U.C.C. § 3-406).

[119] See text at notes 93-107 supra.

Donald for value. If Donald is a subsequent holder in due course, he can recover according to the original tenor regardless of the thief's holder status.[120]

When Donald as a subsequent holder in due course can recover the original amount from Charles, Charles then must seek recourse against Baker. Under the current interpretation of section 3-407(2), the recourse liability of Baker and Able with respect to Charles is dependent upon whether or not the thief qualifies as a holder. Only if the thief is deemed a nonholder does this recourse liability always survive.[121] If the thief is deemed a holder, as the Code seems to require,[122] the recourse rights will persist only by way of subrogation and then only in the event that Donald is a subsequent holder in due course.[123]

In this situation the proposed interpretation permits the court to avoid considering the status of the thief. Charles would be able to overcome Baker's invocation of section 3-407(2)(a) by pointing out that the alteration had not been performed by the holder, presently identified as Charles himself. Baker's chances to escape recovery on the instrument would depend upon proof of defects in the Baker-Charles transaction.[124] To escape recovery by Charles, Able would have to show that Charles was not a holder in due course. It seems preferable that recovery be controlled by these issues rather than by the holder status of the thief, or by the good faith or notice of a subsequent transferee. This approach comports with the well defined Code policy that, as between two parties to a transaction, one party's claim on an accompanying instrument cannot be severed from the defenses originating in the underlying obligation.[125] Moreover, other subsequent defects—*e.g.*, fraud, failure of consideration, incapacity, or theft—have no effect upon the action by one prior indorser against another. There is no apparent reason to make an exception for the case of subsequent alteration. The obligation of the prior parties should be determined only by the current events which they control and, to a lesser extent, by prior events which they can discover.

The question arises, however, whether the result should be any

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120 U.C.C. § 3-407(3).

121 See text at notes 89-92 supra.

122 See note 117 supra.

123 See text at notes 93-103 supra.

124 Since Baker and Charles presumably "dealt with" one another, Charles would not take the instrument free of defects in the underlying transaction even though he might conceivably qualify as a holder in due course with respect to Baker.

125 This is the impact of the "dealt with" limitation upon the holder in due course doctrine: "To the extent that a holder is a holder in due course he takes the instrument free from . . . (2) all defenses of any party to the instrument *with whom he has not dealt* . . ." (emphasis added). U.C.C. § 3-305(2).

different where Donald had notice of the alteration and was unable to recover the original amount from Charles. Under the current interpretation of section 3-407(2)(a), Charles' rights on the instrument are frustrated primarily by the fact that the holder status of the thief is dispositive. If the thief is viewed as a holder, the alteration discharges Able except with respect to subsequent holders in due course.[126] Although a prior indorser such as Charles can qualify as a subsequent holder in due course by way of subrogation, this remedy is unavailable when his potential subrogor has notice of the defect.[127] If the thief is deemed a nonholder, Able is not discharged with respect to Charles. However, this simple expedient is foreclosed by other Code provisions which require that the thief of such an instrument be treated as a holder.[128] Under the present proposal, Charles would encounter none of these difficulties. In a suit against Able or Baker, Charles could avoid the section 3-407(2) defense by arguing that the alteration had not been performed by *the* holder, who is Charles himself. The contract liability of Able and Baker would remain alive and would permit recovery unless Able could show that Charles is not a holder in due course, or unless Baker could invoke a defect in the Baker-Charles transaction.

It may be argued that the proposed solution robs section 3-407(2) of almost all normative content: the "holder" element becomes operative only if the plaintiff is the same person who altered the instrument. Far from being a criticism, this objection accurately describes the main virtue of the proposed interpretation. In the context of a recovery action under section 3-307(2), the alteration defense may, by the very nature of things, be raised only with respect to three possible parties: the altering party, a party who took the instrument before alteration, or one who took subsequent thereto. If the subsequent takers are holders in due course, section 3-407(3) recognizes their rights irrespective of the holder status of the thief and permits them to enforce the instrument. If the subsequent taker is not a holder in due course, then his rights as to the original amount should be controlled by the reasons for this failure to so qualify. Investigation of the holder status of the thief is superfluous.

The alteration is equally irrelevant with respect to the rights and obligations of prior takers. By definition, they had no notice of the alteration when they entered into their section 3-414 contract. It is a tortured reading of the Code to condition their rights *inter se* upon a subsequent event over which they had no control. By analogy to the

126 See text at notes 89-92 supra.

127 See text at notes 93-103 supra.

128 U.C.C. § 3-603 expressly indicates, and § 3-305 implies, that thieves may enjoy holder status.

case of lost instruments, they should be able to sue prior parties upon proof of the original tenor.[129] Their obligations vis-à-vis subsequent takers cannot be viewed differently from the rights of these latter parties over prior takers. Such rights should be governed by the holder's compliance with the elements of due course acquisition.[130]

Consequently, as regards the majority of individuals involved—*i.e.*, the prior and subsequent takers of the instrument—their recovery claims under section 3-307(2) may be resolved without reference to the holder status of the thief. The determinative factors should be (a) qualification as a holder in due course and (b) position with respect to the alteration, *i.e.*, prior or subsequent taker. However, under the current construction of section 3-407(2)(a), these issues are not necessarily reached. The defendant may free himself from liability on the grounds that the alteration was perpetrated by a holder other than the plaintiff.[131] In contrast, the proposed interpretation of section 3-407(2) preserves the contract obligations under section 3-413 and 3-414. Discharge results if, and only if, the alteration was performed by *the* holder who, in a 3-307(2) recovery action, is generally the plaintiff. If either prior or subsequent holders sue under section 3-307(2), the defendant will be able to claim that the alteration was performed by the holder. Consequently, his contract liability will be preserved and recovery will depend upon consideration of notice, good faith, and negligence.

When the altering party, rather than a prior or subsequent holder, appears as a plaintiff in the section 3-307(2) action, there exists good reason for adopting a different approach. If the alteration was material and fraudulent, there is no need to proceed to investigations concerning notice and good faith: the plaintiff, as altering party, may be presumed to have notice.[132] In this situation, the defendant's contract obligations under section 3-413 or 3-414 need not be preserved. Again, the proposed interpretation produces just this result. If the alteration is performed by the holder, who in the context of section 3-307(2) is the plaintiff, then the discharge defense is available to any party, providing that the alteration was material and fraudulent and that it changed that party's contract.

As the Official Comments to section 3-407 make clear, the dis-

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[129] U.C.C. § 3-804: "The owner of an instrument which is lost . . . may maintain an action in his own name and recover from any party liable thereon upon due proof of his ownership, the facts which prevent his production of the instrument and its terms." For a discussion of the difficulties arising under this section, see White, Some Petty Complaints About Article Three, 65 Mich. L. Rev. 1315, 1333-38 (1967).

[130] See text at notes 119-25 supra.

[131] See, e.g., U.C.C. § 3-407(2)(a).

[132] He would then be "a party to . . . [a] fraud or illegality affecting the instrument." U.C.C. § 3-201(1).

charge effect also comes into operation when the alteration was performed, not by the plaintiff under section 3-307(2), but by one of his agents or servants.[133] In the latter case, the initial concern is whether to ascribe the alteration to the plaintiff.[134] Once the alteration is attached to him, immediate discharge is justified since the plaintiff has constructive notice.[135] If the servant's alteration cannot be attributed to the plaintiff, then we no longer have a case where the alteration was performed by the plaintiff holder. The proposed interpretation would preserve the defendant's contractual liability and thus would properly open the way to deliberations concerning his notice and good faith.

V. Double Forgeries and Holder Status of Transferees

The final conundrum arises in a situation[136] in which an employee, Baker, steals blank checks and a signature verification device from his employer, Able. Baker then draws a check to the order of Charles, a fictitious payee, and ultimately negotiates the checks to Donald by delivering them and indorsing Charles' name. Donald gives value and receives the instruments in good faith and without notice. When Donald sues Able on the instrument, Able will certainly invoke section 3-404(1) which declares an unauthorized signature to be wholly inoperative.[137] In reply, Donald will point to Baker's access to the verification device and invoke section 3-406:

> Any person who by his negligence substantially contributes . . . to the making of an unauthorized signature is precluded from asserting the . . . lack of authority against a holder in due course or against a drawee or other payor . . . .

However, Donald's reliance upon section 3-406 requires that he prove himself to be a holder in due course, for he certainly cannot qualify as a "drawee" or "other payor."

Here, again, the thief's indorsement threatens to preclude Donald from acquiring holder status. Donald must qualify for holder status either by way of section 1-201(20), by possessing an instrument indorsed to him or his order, or by way of section 3-202(1), which confers holder status on the transferee if the delivery and indorsement requirements of negotiation have been observed. Under the prevailing

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133 See U.C.C. § 3-407, Comment 3(a).

134 Agency considerations dominated the pre-Code case law regarding the "spoliation" doctrine: see text at notes 83-85 supra and especially authorities cited in note 84.

135 See text at note 132 supra.

136 See, e.g., Palizzi, Forgeries and Double Forgeries Under Articles 3 and 4 of the UCC, 42 S. Cal. L. Rev. 659, 660 (1969) for a discussion of this conundrum.

137 " 'Unauthorized' signature or indorsement means one made without actual, implied or apparent authority and includes a forgery." U.C.C. § 1-201(43).

construction of section 3-202(2), an indorsement must be made by a holder in order to be operative.[138] Thus, Donald's holder status, and his chances successfully to invoke section 3-406, depend upon the holder status of the thief.

In the absence of any negotiation to Baker, section 3-202(1) is inapplicable and Baker's holder status depends solely upon whether or not he qualifies under section 1-201(20). However, Baker fails to fall within the literal scope of that broad provision.[139] Although the instrument was "drawn," it was not drawn to him or to his order or in blank.[140] Although he is in possession of an instrument, that instrument was not "issued" for issuance presupposes an element of delivery.[141] Finally, in the absence of a prior transferee, it is doubtful whether the check was ever "indorsed" to Baker. Consequently, under the prevailing construction of section 3-202(2), Baker's inability to qualify for holder status vitiates the indorsement to Donald, prevents the latter from achieving holder status, and thereby obstructs the applicability of section 3-406. Yet, it is unlikely that the drafters intended Donald to bear the loss if Able was in fact negligent in safeguarding the signature verification device.[142]

Professor Palizzi advances several proposals to remedy this situation which, although they produce the proper allocation of loss, are unsatisfactory in some other respects. First, Baker's use of a fictitious payee is not unlike the case where he used his own name as payee. Had he used his own name, Baker would have been in possession of an instrument "drawn" to his order, hence qualifying him as a "holder" (under section 1-201(20)) who could produce a valid indorsement under section 3-202(2). His indorsee would then qualify as a holder and, eventually, also as a holder in due course for the purpose of invoking section 3-406 against the careless employer. Professor Palizzi argues that, by analogy, the same result should follow where the faithless employee draws the check to a fictitious payee. It is, in his view, artificial to condition access to section 3-406 upon the whim of the

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138 U.C.C. § 3-202(2): "An indorsement must be written by or on behalf of the holder and on the instrument . . . ." See White, Some Petty Complaints About Article Three, 65 Mich. L. Rev. 1315, 1327 (1967); Mellinkoff, The Language of the Uniform Commercial Code, 77 Yale L.J. 185, 192 (1967); Palizzi, supra note 136, at 666 (1969); James Talcott, Inc. v. Fred Ratowsky Associates, Inc. 38 Pa. D. & C.2d 624, 2 U.C.C. Rep. 1134 (1956).

139 U.C.C. § 1-201(20): "Holder means a person who is in possession of . . . an instrument . . . drawn, issued or indorsed to him or to his order or to bearer or in blank."

140 Cf. NIL § 9(3): "The instrument is payable to bearer—when it is payable to the order of a fictitious or non-existing person, and such fact was known to the person making it so payable." The drafters of the U.C.C. explicitly rejected this rule; see U.C.C. § 3-405, Comment 1.

141 U.C.C. §§ 3-102(1)(a), 1-201(14).

142 See U.C.C. § 3-406, Comment 7 (sentence 2).

faithless employee.[143] However, Baker did in fact draw the instrument to a fictitious payee. Unless the meaning of "draw" and "order" in section 1-201(20) is contorted, it is difficult to view the resulting instrument as one payable to Baker or to his order or to bearer or in blank.[144]

It is in the nature of most statutory schemes that the dictates of specific statutory language cannot be overcome through argument by analogy. Moreover, as regards the availability of relief under section 3-406, it is not necessarily capricious to distinguish between transferees of fictitious payee checks and transferees of checks payable to the faithless employee. In practice, checks are not treated as negotiable paper;[145] they are generally deposited by the payee for collection. Payroll checks are, by way of exception, occasionally negotiated once, often to a grocer or check-cashing service, and then deposited for collection. The party who gives the faithless employee value for the fictitious payee check is not acting in accordance with this common business custom. Even assuming that the item has the appearance of a payroll check, the fictitious payee check purports on its face to have already been negotiated from the fictitious payee to Baker. In contrast, the party who gives the employee value for the check, payable to the employee's order, is acting in accordance with the custom which permits a single negotiation of a payroll check.

Professor Palizzi's second proposal seeks to establish Donald's holder status by reference to section 3-405(1)(b):[146]

> An indorsement by any person in the name of a named payee is effective if . . . (b) a person signing as or on behalf of a maker or drawer intends the payee to have no interest in the instrument.

If applicable, this section would make effective Baker's indorsement to Donald and would enable the latter to qualify for holder status under either section 1-201(20) or 3-202(1).[147] Although the case falls within the literal language of section 3-405(1)(b), the provision presupposes a drawer who, in contrast to Baker, is actually authorized to sign the drawer's name.[148] Finally, Professor Palizzi suggests that, for purposes of section 3-406, *holder* in due course should be read as

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143 See Palizzi, supra note 136, at 668-69.

144 As regards the difficulties in applying U.C.C. § 1-201(20) to instruments payable to fictitious payees, payees without an interest, and agents without authority, see discussion at note 30 supra.

145 See Rosenthal, Negotiability—Who Needs It? 71 Colum. L. Rev. 375, 382 (1971).

146 See Palizzi, supra note 136, at 669-70.

147 Both sections presuppose a valid indorsement as an element of holder status.

148 See U.C.C. § 3-405, Comment 3(d)-(g); Palizzi, supra note 136, at 670.

transferee in due course.[149] However, in light of the distinction between transferee and holder throughout Article 3,[150] such a proposal represents a significant incursion upon the statutory language.[151] It would be far less objectionable to resolve the difficulties by reference to section 3-405(1)(b) since the facts fall within the literal meaning, as well as the broader intention, of that provision.[152]

Although Professor Palizzi's proposals will permit the loss to be shifted onto Able, they fail—as does Professor White's analysis of the effects of conversion on the holder status of subsequent transferees —to respond to the underlying problem. That problem, once again, is the proper construction of the requirement of section 3-202(2) linking an indorsement with holder status. The puzzles discussed by Professors Palizzi and White are largely of their own making. Both commentators, without further discussion, embrace an interpretation of section 3-202(2) which predicates an indorsee's holder status upon the holder status of his indorser.[153] As a matter of statutory construction, this interpretation is at best tenuous: it is based solely on a negative implication[154] which is repeatedly contradicted by other Article 3 provisions.

With respect to the present problem, the negative implication is indirectly controverted by sections 3-305 and 3-603(1) both of which

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149 See Palizzi, supra note 136, at 670-71.

150 The distinction appears most clearly in the following series of provisions: "Transfer of an instrument vests in the transferee such rights as the transferor has therein . . . ." U.C.C. § 3-201(1). "Negotiation takes effect only when the indorsement is made . . . ." U.C.C. § 3-201(3). "Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement . . . ." U.C.C. § 3-202(1).

151 "Transfer" refers to the beneficial interests in the instrument whereas "holder" refers to right to transfer, enforce, or discharge the instrument; see U.C.C. § 3-301. As is the case in the collection process, holder status may be in one party and ownership rights in another; see U.C.C. § 4-201(1).

152 Section 3-405(1)(b) nowhere explicitly requires that the drawer of the fictitious payee instruments be authorized to draw on the account; the section refers only to "the person signing *as* or on behalf of *the maker or drawer*" (emphasis added). Nor is any such limitation contained in the first three examples provided to illustrate the operation of the section: "The drawer of a check, for his own reasons, makes it payable to P knowing that P does not exist." U.C.C. § 3-405, Comment 3(a). The admitted policy of the fictitious-payee provisions is to shift the loss to the party (here, the employer) who is in a superior position to prevent the loss, who is better able to cover the loss by fidelity insurance, and with respect to whom the loss may be most properly regarded as an expense of doing business. U.C.C. § 3-405, Comment 4. In the face of this policy and the lack of an explicit restriction, it seems somewhat strained to distinguish between an employee who writes fictitious payee checks within the apparent scope of his authority (i.e., a payroll clerk) and an employee who is able to write fictitious payee checks by virtue of his access to a signature verification device (i.e., the personal secretary of a corporate officer).

153 See notes 16-17 supra and accompanying text.

154 See text at notes 27-34 supra.

indicate that Baker's role as a thief does not necessarily preclude Donald from acquiring holder status.[155] Sections 3-203, 3-207(1)(d) and 3-405(1)(b) go further and explicitly contradict this implication. Where an instrument is made payable to a person under a name other than his own, section 3-203 permits indorsement in that name. Although this provision probably contemplates wrongly designated or misspelled names, neither the statutory language nor the Official Comments specifically restrict the operation of the provision to such cases. The present facts fall within the literal scope of the section. Where the faithless employee (Baker) draws the instrument to a fictitious payee, he comes to Donald with an instrument "made payable to a person under a . . . name . . . other than his own."[156] Section 3-203 recognizes an indorsement in that name or Baker's own name. The indorsement provides the basis for Donald's holder status. Section 3-207(1)(d) deems effective a negotiation made in breach of duty.[157] The actions of the faithless employee in using the blank checks and signature verification device certainly represent a breach of duty to his employer. If this breach of duty may be subsumed under section 3-207(1)(d), and neither the provision nor the Comments contain any limiting language, then the negotiation to Donald will be deemed effective. Under section 3-202(1) the negotiation will provide a basis for Donald's holder status. As discussed above, the facts fall within the literal language as well as the policy scope of section 3-405(1)(b), which renders effective an indorsement upon fictitious payee paper.[158] The effective indorsement will enable Donald to qualify for holder status and thus, eventually, to invoke section 3-406 against the careless employer.

It will be argued that application of those provisions to the present facts goes far beyond the drafters' intent. However, as an examination of each provision demonstrated, neither the statutory language nor the comments preclude their application in the present circumstances. In the absence of some explicit manifestation of legislative intent, it seems fair to regard the scope of the provisions as an open question, pending a judicial interpretation. Indeed, one may even argue that the presence of so many potentially broad validation provisions indicates a general legislative policy in favor of viewing

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[155] See discussion at note 128 supra.

[156] "Where an instrument is made payable to a person under a misspelled name or one other than his own he may indorse in that name or his own or both . . . ." U.C.C. § 3-203.

[157] "Negotiation is effective to transfer the instrument although the negotiation is . . . (d) made in breach of duty." U.C.C. § 3-207(1)(d). Neither the statute nor the Comments impose any restriction upon the term "breach of duty."

[158] See note 152 supra.

possession and regularity as the sole constituents of holder status.[159] As argued elsewhere, any additional requirements defeat the reliance function served by holder status within Article 3[160] and inevitably encroach upon the operation of other key notions such as due course, notice and good faith.[161] These considerations rather conclusively suffice to deprive the negative implication contained in section 3-202 (2) of any normative significance whatsoever. For those unwilling to go so far, the language and intention of section 3-405(1)(b), and the analogy to the case where the thief (Baker) uses his own name as payee,[162] are sufficient to overcome the negative implication of section 3-202(2) as it operates in the double forgery puzzle.

Conclusion

The significance of the holder concept has been grossly overemphasized. The result has been a number of inconsistencies which appear to strike at the very heart of the "Article Three machine."[163] The most important conundrums—negotiation by a thief, double forgeries by a thief, and the significance of alteration by a nonholder —all result from a predisposition to elevate negative implications into positive norms. In the case involving negotiation by a thief, reliance upon the negative implication of section 3-202(2) is precluded by the explicit provision to the contrary contained in section 3-207(1)(d), which permits negotiation by nonholders. As it appears in the double forgery puzzle, the negative implication of section 3-202(2) is also overcome by the language and intention of sections 3-405, 3-203, 3-207 and 1-201(20). The additional problems raised by the negative implication contained in 3-407(2) result from a misreading of 3-407 (2)(a). Within the context of a recovery action under section 3-307 (2), "the holder" should be properly read as referring only to the plaintiff. The only time discharge under section 3-407(2)(a) is desirable is when the plaintiff or his servant has performed the alteration. Otherwise, the defendant's contractual liability under section 3-413 or section 3-414 should be preserved in order that the issue of notice and good faith become dispositive of the dispute. The interpretations proposed in this article would provide a measure of consistency.

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159 See notes 34-35 supra, and accompanying text.

160 See text at notes 38-44 supra.

161 Expansion of the holder concept to include more than regularity and possession leads to discharge for want of a valid indorsement (U.C.C. § 3-202(2)), discharge for spoliation (U.C.C. § 3-407(2)(a)), and discharge for inability to invoke the maker's negligence (U.C.C. § 3-406); one does not reach the issues of notice, good faith, and negligence. In contrast, these issues are preserved if "holder" is defined strictly in terms of possession and regularity.

162 See text at notes 142-45 supra.

163 See White, supra note 138, at 1315.

More importantly, they would shift the focus of analysis from the relatively sterile holder concept to the more fertile elements of the holder in due course doctrine.[164]

[164] To the extent that the holder concept is construed to entail anything more than regularity and possession, it comes to resemble the notion of title. The functional disutility of the title concept in a commercial setting is evidenced by the drafters' total rejection of that concept in framing the rights and duties of parties under Articles 2 and 9; see U.C.C. §§ 2-401 (preamble) and 9-202.